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Emerging Markets Queries in Finance and Business

How does the size effect influence the Romanian investors' strategy?

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Abstract

The size effect implies that small firms experience large returns. This paper examines the size effect pattern on the Romanian stock market. The observation period was divided into sub–periods: January 2003 – December 2007 before crisis and January 2008 – December 2010 during crisis. We found that the size effect does not occur either before the financial crisis, or during the crisis. In the first part of the paper a review of literature regarding the existence of the size effect on different markets is presented. It could have been observed that the size anomaly is present and robust through the years in most countries of the world. Further on, the paper presents the methodology and the data that were used, but also the empirical results that were obtained for each observation period. In the last part of the paper, the conclusions that resulted from the analyses are presented, along with their importance for the investors when choosing an investment strategy.

Keywords: size effect, Romanian capital market; portfolio; market capitalizatio;

1.Introduction

The size effect is a very important anomaly for the capital market. The given hypothesis is that this effect is present especially during the financial and political crisis, due to the fact that the risk aversion leads the investors to buy excessively "blue-chips". The size effect is defined from an empirical point of view, and it can be observed that companies with smaller capitalization register abnormally high yields compared to those which register high capitalization values.

This finding is difficult to explain – especially given the fact that most *a priori* risk measures fail to account for the gap.

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Additional transaction and liquidity costs can only partly explain this effect. Taxation or window-dressing-based explanations have also been questioned by counterexamples. As data on individual investor behavior are not available in large quantities, studies in this field typically use the variation of stock returns over time to test hypotheses.

The reason for choosing this topic is to observe the existence of this anomaly on the Romanian market, in order to help the investors to establish a profitable investment strategy.

Banz and Ringanum was the first to discover this anomaly in their event study from 1981. Using data from the New York stock exchange, they showed that small capitalized firms produce higher returns on average than large capitalized firms. Some argue that the size-effect have disappeared, especially since it has been documented that the effect has been declining since 1982.

The rationale for the size anomaly's existence over time may lie in investors not fully realizing the potential earning power of Small Caps and, perhaps, overpaying for perceived safety. The size anomaly is another example of the market not being able to properly reflect current conditions and future expectations in current stock prices.

Since institutions, which dominate the market, migrate from category to category, they may shift from once-favored stocks - such as large companies - and move into small caps.

The present paper examines the size effect pattern on the Romanian stock market, during two periods: before the financial crisis January 2003 – December 2007 and during the financial crisis January 2008 – December 2010.

In the first part of the paper a review of literature regarding the existence of the size effect on different markets is presented. It could have been observed that the size anomaly is present and robust through the years in most countries of the world.

Further on, the paper presents the methodology and the data that were used, but also the empirical results that were obtained for each observation period.

In the last part of the paper, the conclusions that resulted from the analyses are presented, along with their importance for the investors when choosing an investment strategy.

2.Literature Review

The predictability of stock returns has been a core topic among academic researchers in financial economics as well as industry practitioners for years. Any new documented persistent stock anomaly will attract significant interest among researchers and practitioners as it provides the prospect of making abnormal returns for investors. The size effect has been widely studied for a profitable investment strategy and different theories have been raised to explain this phenomenon.

The size effect is one of the oldest and most important anomalies. Since Banz, 1981, reported that small firms have higher returns than large companies, many researches have been made based on these findings. The market risk of the securities with small capitalization is undervalued when measured by the parameter beta. Reinganum, 1981, studied the size effect on the U.S. market, dividing the analyzed companies by size capitalization in 10 categories, for which he has not found great differences regarding the parameter beta it was close to the market, but it could have been observed a much higher return from the companies with low capitalization. Thus, there was a persistence of size effect. Roll, 1983, considers that this anomaly depends of the way that the returns are aggregated into a portfolio.

Other studies have examined closely the returns obtained according to the market capitalization. Brown et al., 1983, analyzed the size effect based on annual data, noting that the magnitude of the size effect has changed from year to year, and also claiming that these changes are not deviations from the average effect, but rather deviations from the average, which were recorded over time.